Catholic University Law Review

Volume 25
Issue 4 *Summer 1976*

Article 5

1976

The Role of the Federal Reserve in Electronic Funds Transfer – An Executive Perspective

John Eger

THE ROLE OF THE FEDERAL RESERVE IN ELECTRONIC FUNDS TRANSFER—AN EXECUTIVE PERSPECTIVE

*John Eger**

In the past two decades, Americans have witnessed the rapid convergence of telecommunications and data processing and have embraced the remarkable by-products of that convergence. Those by-products have generated dramatic new capabilities in such diverse endeavors as space travel, high speed rail transportation, emergency health care, legal research, criminal justice, large scale inventory control, and banking. However, these new capabilities are not free from the perplexing problems which frequently accompany profound technological change. Such change can suddenly bankrupt the rationale behind either a particular industry's existence or a participant's involvement in that industry. Furthermore, while such new capabilities often address problems peculiar to the old technology, by their very nature they can create new and unforeseen problems.

On January 12, 1976, the Board of Governors of the Federal Reserve System issued notice of a proposed rulemaking change to Regulation J.[1] While this may appear to be simply a minor administrative adjustment to the Federal Reserve's rules and regulations, it signals one of the more prominent developments in the establishment of a national electronic funds transfer system. By presenting this proposal to an open forum, the Federal Reserve Board has given the public not only a glimpse of the policy problems which the Board must resolve but, more importantly, has granted the public an opportunity to openly reflect on the Board's involvement in electronic funds transfer systems (EFTS). This article will address the problems inherent in such involvement. The issues discussed here, however, should not be construed as ones which are limited to the activity of the Federal Reserve; indeed,

---

* Acting Director of the Office of Telecommunications Policy, 1974-1976. B.A., 1962, Virginia Military Institute; J.D., 1970, John Marshall Law School.

1. 41 Fed. Reg. 3097 (1976). See text accompanying notes 17-23, 28-32 *infra* for discussion of Regulation J and the proposed amendments.

they apply to all governmental involvement in any EFT system.

I. THE CLEARING HOUSE

During the 1960's, the number of checks written on demand deposit accounts increased to the point at which, in 1970, the total number of checks that the payments transfer system was required to process was about 22.5 billion.[2] In seeking to cure many of the problems generated by such a large volume of paperwork being transported through the funds transfer system, the Federal Reserve turned to automated data processing. As a result, the automated clearing house came into practical use during the early 1970's.[3] However, its use was limited to the physical delivery of electronic payment information by means of magnetic tape. The obvious capability of the telecommunications system to transport this electronic information has not yet been used by the automated clearing houses.

Despite this technological paradox, it is obvious that the next step will be to link the automated clearing houses via telecommunications. This interconnection, however, is not a simple matter. Aside from the technical problems that might arise, two major policy questions are generated. At the outset, it should be observed that the technology which the Federal Reserve is attempting to embrace, namely, the convergence of telecommunications with data processing, has bankrupted the rationale upon which the Board has established itself as the operator of the national payments transfer system. To the extent that payments are transferred electronically, it is no longer necessary for an arm of the federal government to provide clearing services. As paper disappears from the system, so does the rationale for Federal Reserve involvement. Furthermore, if the Board engages in operating an electronic funds transfer mechanism on a national scale, then new problems are certain to materialize, particularly within the realm of privacy. Therefore, because of the debilitating influence of the new technology upon the Board's present reason for operating the national payments clearing mechanism, and because of the new problems that are certain to be generated by the Board's involvement, the Board should eschew direct involvement as an operator of EFT services. Rather, it should embark upon a deliberate withdrawal from its existing level of EFT involvement and confine its role to regulating and monitoring the EFT system.

---

2. ARTHUR D. LITTLE, INC., THE CONSEQUENCES OF ELECTRONIC FUNDS TRANSFER 50 (1970).

3. *Id.* at 98-101.

A. Development of the Clearing House Concept

Formalized clearing house activity in the United States had its origin in the establishment of the New York Clearing House Association on October 4, 1853.[4] The number of private clearing houses in this country grew to over 300 by the mid-1920's.[5] However, with the advance of the industrial revolution, the consequent growth of the nation's economy, and the increase in the nation's population and mobility, private clearing houses became less and less capable of efficiently managing the payments system on a national scale. Under that paper-based system, the complexity of clearing millions upon millions of checks became unworkable at the national and regional clearing points.[6] With the passage of the Federal Reserve Act in 1913,[7] the federal government created an agency, the Federal Reserve Board, that would be directly involved in operating these overburdened clearing points. Congress, in the Act, gave the Board permission to engage in clearing house activities; however, in granting that authority, Congress was extremely careful to withhold a *mandate* for the Federal Reserve to create a universal clearing system. Indeed, in 1923 the Federal Reserve Bank of Richmond was severely admonished by the Supreme Court for having been so bold as to suggest that it possessed such a mandate.[8]

This discretionary clearing function was included in the Act not so much because the Federal Reserve System was expected to function as a central banking authority, but more as a result of concerns about ineffective transportation and the inability to clear items from rural and western banks.[9] The problems of transportation and distance were so perplexing in the clearing process that even the Federal Reserve did not believe itself capable of providing clearing services for all potential affiliated institutions.[10] The complexity

4. Andrews, *The Operation of the City Clearing House*, 51 YALE L.J. 582, 587 (1942).

5. *Id.*

6. Hock, *EFTS or EVE*, in THE ECONOMICS OF A NATIONAL ELECTRONIC FUNDS TRANSFER SYSTEM 65, 71 (Federal Reserve Bank of Boston, Conference Series No. 13, 1974).

7. 12 U.S.C. § 248(o) (1970) (originally enacted as the Federal Reserve Act of 1913, ch. 6, §§ 11, 16, 38 Stat. 261, 262, 265). For a history of the Act, see LAUGHLIN, THE FEDERAL RESERVE ACT, ITS ORIGINS AND PROBLEMS 3-208 (1933). *See also Hearings on H.R. 7837 Before the Comm. on Banking and Currency*, 63d Cong., 1st Sess. (1913).

8. Farmers & Merchants Bank v. Federal Reserve Bank, 262 U.S. 649, 664 (1923). *See also* Community Bank v. Federal Reserve Bank, 500 F.2d 282, 289-90 (9th Cir. 1974).

9. A. LINK, WILSON: THE NEW FREEDOM 199-240 (1956).

10. *Cf.* Fergus County v. Federal Reserve Bank, 75 Mont. 582, 244 P. 883 (1926).

in handling the payments clearing system has been suggested as a third reason for the Federal Reserve's involvement.[11] This complexity was exacerbated by the increasingly diverse locations of the population, which created an atmosphere conducive to direct government involvement in an otherwise private sector activity.

B. Technology's Impact on the Clearing House

The rationale for direct Federal Reserve operation of the national clearing houses is historically based upon problems arising from distance, transportation and the complexity of processing the paper-based information. The capabilities of today's telecommunications technology, however, have effectively eliminated these problems. Simply put, the present state of the art in telecommunications has eliminated the need for the Federal Reserve to operate an electronic payment system.

In an electronic system, the three fundamental reasons for Federal Reserve operation of the paper-based clearing system evaporate. As for the distance factor, technology can bring the entire information universe within immediate reach.[12] Once credit or debit information is reduced to electronic impulses and placed upon a telecommunications system, distance between an originator and a recipient becomes largely irrelevant. With the elimination of distance as a constraint, the transportation motive behind a direct Federal Reserve operation of the clearing houses disappears. In an electronic system, information that was once transported physically around the country is now capable of traveling at the speed of light, somewhere in excess of 180,000 miles per second.

The third motive for Federal Reserve involvement, system complexity, becomes similarly noncritical in an EFT environment. In the paper-based system, the problem was not only the complexity of transferring information but also the maintenance of effective control over the large volume of paper upon which the information rested. Accordingly, as one neared the central clearing houses, the complexity of the clearing process increased dramatically. In an electronic system, however, the movement of physical objects within the system becomes nonexistent. Additionally, the most complex stage in the process shifts from the core of the system to its periphery.[13] The periphery of any electronic data system is responsible for the entry of the data on one side and its storage on the other. The core becomes an inanimate computer-

11. *See* Hock, *supra* note 6, at 71.

12. *See* Morton & Ernst, *The Social Impacts of Electronic Funds Transfer*, 13 IEEE TRANSACTIONS ON COMMUNICATIONS 1148 (1975).

13. *See* Hock, *supra* note 6, at 71-72.

ized switch that could be owned by any one of several entrepreneurs and operated as efficiently and securely as the Federal Reserve operates today's paper-oriented clearing houses. Indeed, a number of clever entrepreneurs in the financial and bank card industries have already established themselves in this market.[14] Accordingly, if the Federal Reserve sought to operate the most complex stage in the new system, it would find itself moving inexorably toward the periphery of the system, an area in which the private sector has already demonstrated its eagerness to participate.[15] Furthermore, in addition to those private companies now involved in this market, new entrants in the telecommunications and data processing industries are providing specialized switching services that are easily adaptable to an electronic payments system, and several have sought and received authority from the Federal Communications Commission to provide services quite similar to those which the Federal Reserve appears to be contemplating.[16] In sum, the elimination of these historical constraints upon the payments transfer system reduces the scope of the clearing task from the unmanageable dilemma of the 1920's to a situation that is now quite manageable by the private sector. Consequently, the complexion of our payments system is undergoing dramatic and far-reaching technological changes, and those changes are creating an environment which may well be inhospitable to direct Federal Reserve operation.

II. Regulation J

A. Current Provisions

Section 16 of the Federal Reserve Act requires that the Board promulgate regulations governing the warranties, liabilities and other obligations involved in the provision of clearing house services to Federal Reserve Banks.[17] Those regulations are embodied in Regulation J,[18] which is subject to parochial adjustment by the Federal Reserve Banks as they issue their operating letters governing the details of their clearing house operations.[19] Regulation J applies uniquely to the clearing houses operated by the Federal Reserve,

14. *Id.* at 72-74.

15. *See, e.g., id.* at 72-73.

16. *See* Berman, *Computer or Communications? Allocation of Functions and the Role of the Federal Communications Commission*, 27 Fed. Com. B.J. 161, 162-68 (1974). *See also* Telenet Communications Corp., 46 F.C.C.2d 680 (1974); Graphnet Systems, Inc., 44 F.C.C.2d 800 (1974); Packet Communications, Inc., 43 F.C.C.2d 922 (1973).

17. 12 U.S.C. § 248(o) (1970).

18. 12 C.F.R. § 210 (1975).

19. *Id.* § 210.16 (1975).

and to the extent that the clearing process is associated with a private clearing house, Regulation J does not seem to apply.

As presently written, Regulation J views clearing house activity as a peculiarly paper-oriented phenomenon.[20] In 1967, it was amended to embrace more precisely the Uniform Commercial Code's (UCC) definition of an "item" as "any instrument [used] for the payment of money . . . ."[21] While Regulation J itself does not define the term "instrument," explicit language in a comment to article 4 of the UCC seems to limit its applicability strictly to paper.[22] This limitation is confirmed by language in the recently promulgated notice of proposed rulemaking which states that nonpaper (*i.e.*, electronic) transfers are now governed by operating letters and not by the terms of Regulation J.[23]

Despite this limitation of Regulation J's impact to paper-oriented clearing houses, the Federal Reserve's development of electronic funds transfer capabilities does not seem to have been impeded. On June 17, 1971, the Board of Governors issued a policy statement that sought "basic changes in the Nation's system for handling money payments . . . [as] essentially transitional steps toward replacing the use of checks with electronic transfer of funds."[24] Later, in December 1972, a Federal Reserve Bulletin stated that: "It is anticipated that the Federal Reserve will install and manage a nationwide communications network through which interregional settlements between financial institutions will be made."[25] Finally, in October 1974, George W. Mitchell, then Vice-Chairman of the Board of Governors of the Federal Reserve System, told an audience in Boston that:

> [A]ll Reserve Banks have installed integrated communications equipment. This wire network—in addition to the surface and air courier systems for the movement of paper—now provides the Federal Reserve with the capability to deliver payments by check, magnetic tape, hard copy, and wire form to any bank in the nation, and for that matter to any other depository institution via a commercial bank.[26]

---

20. *Id.* § 210.2(a) (1975).

21. 32 Fed. Reg. 10912 (1967).

22. *See* UNIFORM COMMERCIAL CODE § 4-104, Comment 4. "The word 'item' . . . is 'banking language' and includes non-negotiable as well as negotiable paper calling for money and also similar paper governed by [articles 3 and 8] . . . ."

23. 41 Fed. Reg. 3097, 3098 (1976).

24. 57 FED. RES. BULL. 546 (1971).

25. 58 FED. RES. BULL. 1010 (1972).

26. Mitchell, *Agendas for Action on the Payments Mechanism*, in THE ECONOMICS OF A NATIONAL ELECTRONIC FUNDS TRANSFER SYSTEM 9, 10-11 (Federal Reserve Bank of Boston, Conference Series No. 13, 1974).

An indication of the extent of the Federal Reserve's involvement in the deployment of electronic funds transfer facilities is the fact that there are now 21 operational automated clearing houses, 19 of which are operated by the Federal Reserve.[27]

B. *Proposed Changes to Regulation J*

The regulations contained in the Federal Reserve's notice of proposed rulemaking have several sections that collectively provide the Federal Reserve with the legal framework within which it could operate its EFT facilities online—that is, fully coupled via telecommunications.[28] As mentioned earlier, Regulation J currently limits the form in which funds may be transferred to traditional "items and instruments"—that is, the normal paper instruments that one associates with traditional checks, notes or drafts.[29] Section 210.52 of the proposed regulations redefines these financial instruments and items. Of critical importance is subsection (c), which defines "instrument for the payment of money" as "any writing contained in or on any medium approved by section 210.53 for the issuance, transmission, or recording of credit items, addressed by one person to another and evidencing a right to the payment of money."[30] Subsection 210.53(c) defines "items" as "any form of communication, other than voice, that is registered upon, *or is in* [*a*] *form suitable for being registered upon* magnetic tape, disc, or any other medium designed to capture and contain in durable form conventional signals used for the electronic communication of messages."[31] This definition is incorporated by reference into section 210.72 and thereby applies to debit items as well.[32] A major purpose of section 210.53 is to define an "item" not just in terms of a physical medium, but also in terms of ephemeral electronic impulses which can be registered on a medium. These impulses are precisely the traffic carried by all telecommunications systems, and the instantaneous exchange of these impulses on a telecommunications network is the essence of EFT. Accordingly, the proposed changes cannot be viewed as an expeditious resolution of some mechanical problems that have arisen in today's paper-based clearing houses. Rather, these amendments to Regulation J would permit almost any activity that could be carried on in a full EFT environment to be conducted by the Federal Reserve. In particular, the scope and direc-

27. NATIONAL AUTOMATED CLEARING HOUSE ASSOCIATION, NACHA QUARTERLY UPDATE 6 (Apr. 1976).

28. These proposed sections are 210.52, .53, .72, and .75; *see* 41 Fed. Reg. 3099-3100, 3102-04 (1976).

29. 12 C.F.R. § 210.2 (1975).

30. 41 Fed. Reg. 3100 (1976).

31. *Id.* (emphasis added).

32. *Id.* at 3102.

tion of the amendment to Regulation J in conjunction with the continued operation of the present Federal Reserve Communications System would cast the Federal Reserve in the role of providing the services necessary to sustain its EFT system on-line. In other words, the Federal Reserve would be the vendor of the core of the nation's EFT services. The Board's historic role in the clearing mechanism of this nation would, under the pressures of dramatic technological change, push it ultimately into the role of operator and manager of the essential telecommunications services supporting an EFT system.

III. Inherent Dangers of Federal Reserve Control

Electronic funds transfer is the product of an interconnection of computers with telecommunications and, on its simplest level, creates the capacity to directly interconnect the records which indicate the availability and transferability of funds in an individual's accounts. Those accounts may be in the names of banks, as in the current Federal Reserve System, in the names of a variety of nonbanking institutions, or in the names of individual citizens. In any EFT system the transfer of funds will result in the exchange of extensive account information between a wide variety of accounts.

The dangers of federal control are partially the result of the incredibly rapid innovation and technological change that have been a part of both the computer and telecommunications industries in recent years. Few experts will argue the fact that a new generation of computer hardware or software techniques will occur about every five years. With such rapid innovation and the concomitant competition that has accompanied it, tremendous benefits have already accrued to the government and to society at large. To sanction governmental control of certain technologically provided services would only result in stifling the innovation that has already occurred in this field. Indeed, the mere threat of federal intervention could chill the development and provision of private sector services. It is axiomatic that entrepreneurs in our free enterprise system will not commit nonrecoverable capital to programs that are likely to be rendered useless by action of the Federal Reserve Board. For an entrepreneur to do so, particularly after having been forewarned, would indicate callous disregard for the welfare of the enterprise, resulting in personal liability at best, and corporate fatality at worst. Accordingly, the threat of development or expansion of an operational role for the Federal Reserve could well discourage competition, innovation and efficiency in the provision of EFT services.

In addition, there is a danger that governmental operation of such a system may ultimately pose very real threats to the privacy of individual citizens.

Any EFT system has the potential to be a highly effective tool for policing the behavior of American citizens. A detailed monitoring of the information carried on such a system could easily generate data on a user's buying habits, political activities, physical movements, and nearly every other aspect of his personal life. To acknowledge such a potential, however, is not to suggest that it is inevitable. EFT, like other systems of automated personal documentation, is a complex technical instrumentality which obeys no purposes other than those which are assigned to it. Since our society is one in which the guarantees of personal liberty are of paramount value, I believe that the dangers of unfettered government access to the "electronic footprints" of American citizens must be carefully evaluated before we can consider committing ourselves to government operation or control of EFT services.

Fear of the dangers to individual privacy resulting from government operation and control of EFT services has evoked extensive criticism of proposed EFT systems. Recent testimony by Donald Alexander, Commissioner of the Internal Revenue Service (IRS), and Deputy Attorney General Harold Tyler before the Privacy Protection Study Commission is ample evidence of the immediacy of these dangers.[33] As Commissioner Alexander testified, while the IRS was created as an independent agency, and while its records were intended to be used only for income tax purposes, it has become a repository in which other agencies of the federal government seek information for criminal prosecution, as has been done by the Justice Department in cases of political harassment.[34] Deputy Attorney General Tyler indicated that he believes such access to the records of other government agencies is necessary for the effective functioning of the Justice Department and other law enforcement systems.[35]

In the past, the Federal Reserve has had little information which would excite the interest of the Department of Justice or other law enforcement agencies. However, with the advent of EFT, the Federal Reserve could provide access to a great deal of information flowing through an EFT system. The convergence of high speed microwave telecommunications technology with the developments in computer technology creates information flow capabilities of colossal magnitude. Pressure by other government entities to gain

33. *See Hearings on Federal Tax Return Confidentiality Before the Privacy Protection Study Comm'n*, Mar. 11, 1976, at 9-104. (Available at Privacy Protection Study Commission, Washington, D.C.).

34. *See id.* at 25-33.

35. *Id.* at 56-60. Tyler cited the lack of recorded incidents of abuse of access and the Justice Department's need to fulfill its statutory duties as reasons for allowing continued access.

access to this new source of information would be inevitable if the Federal Reserve Board were functioning as the operator of the EFT services, and there is little reason to believe that the Board would be any more successful in resisting such pressure than the IRS has been in the past. For these reasons, the questions of privacy and confidentiality are more than mere hypotheticals.

IV. Conclusion

In reviewing the early developments in EFT, it is important to remember that we are not merely applying first aid to our paper-based funds transfer system. On the contrary, there is every reason to believe that we are fashioning tomorrow's payments mechanism out of the computer-telecommunications system. As such, it is incumbent upon today's decisionmakers to insure that the errors of the past not be repeated. Furthermore, to the extent that technology reshapes the underlying premises of our payment system, EFT policy should reflect those changes. Thus, it is the long range effects that we must focus upon in our review of Regulation J, and not the short term relief that a change to Regulation J might offer for a handful of problems that have arisen in the existing payments system. Once one comprehends the probable development of the full EFT system, the significance of the proposed amendments to Regulation J becomes obvious, and the compelling reasons against the Federal Reserve's operational control of the system become dramatically exposed.